Resolution Foundation
BRIEFING

Counting the cost

UK living standards since the 2016 referendum

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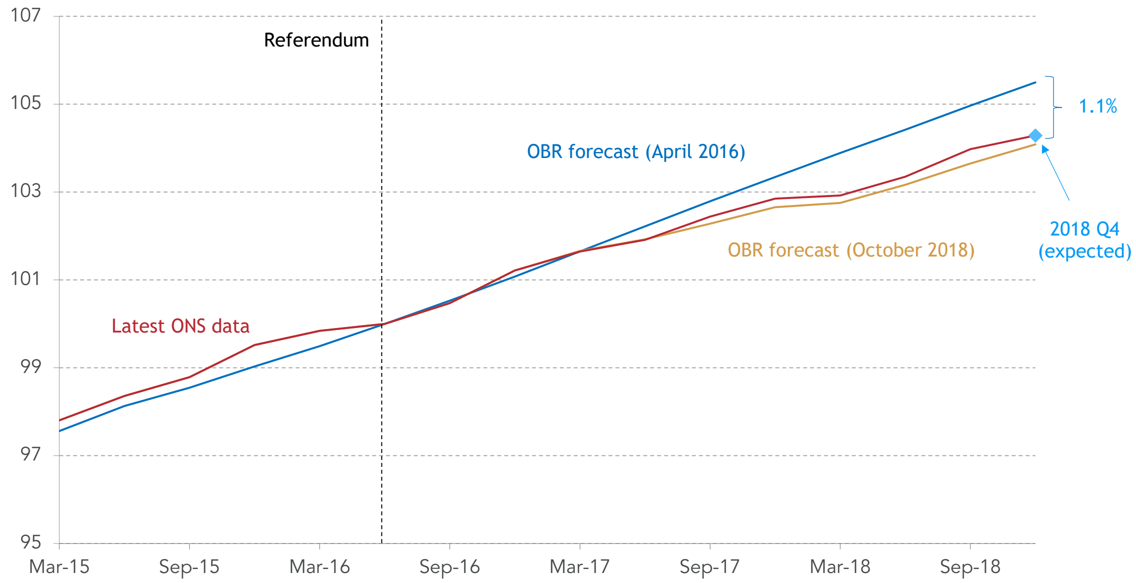
Counting the cost

Later today the Office for National Statistics will present its first estimate for economic growth in the last quarter of 2018. It is expected to be weak, with economists predicting growth of just 0.3 per cent (according to HMT's Forecast panel).[1] This is well below pre-crisis average growth of 0.7 per cent. Everyone will agree that this slow growth is bad news, as the Bank of England did last Thursday, and then disagree violently about how much this reflects the impact of Brexit – with some saying it has more to do with recent signs that the world economy has been slowing. Untangling the two in the narrow context of one quarter's data is a fool's errand. Instead, an easier and more important question to ask is: what effect has both the Brexit referendum decision, and the nature of the political process since then had on our economy, and most importantly on household living standards?

To start to get a handle on this question we can look back at the whole period since the referendum and compare the level of GDP in the latest data to the OBR's March 2016 pre-referendum forecast (which assumed the UK would remain in the EU). Building on economists' expectation for 2018 Q4 to the ONS data suggests the economy is 1.1 per cent smaller than that pre-referendum forecast. In annual GDP terms that's worth around £23 billion, or about £800 per annum for every household in the UK.

Figure 1: GDP has turned out weaker than the OBR's pre-referendum forecast

Index of real GDP (2016 Q2 = 100)



Source: OBR and RF calculations

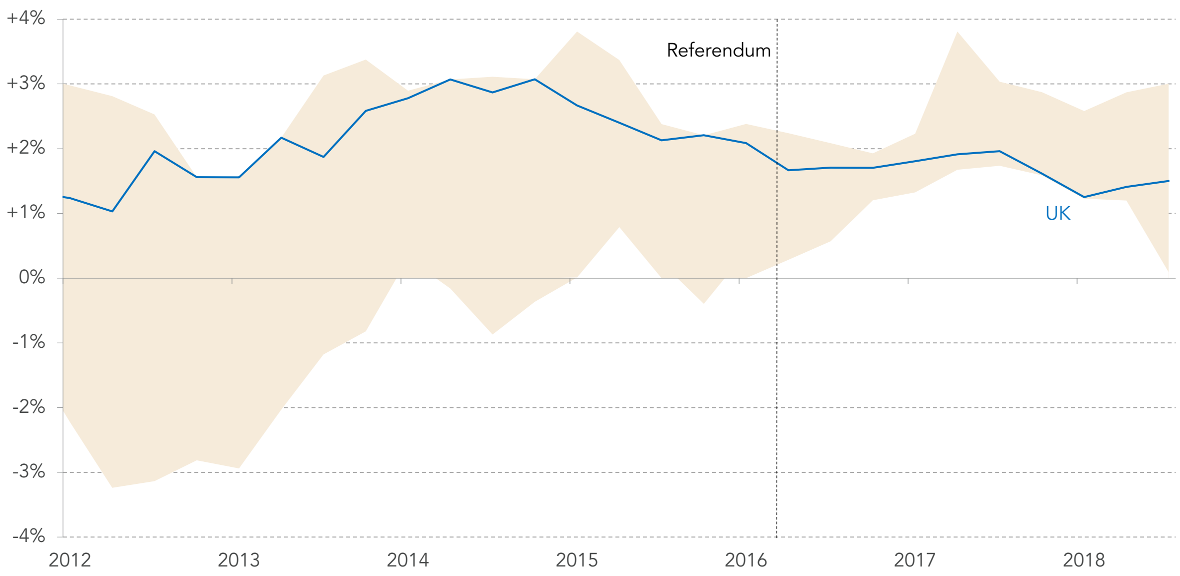
[1] HM Treasury, Forecasts for the UK economy, January 2019

But there are two problems with this sort of very simple comparison. First, it risks misattributing changes in the outlook to Brexit when something else is going on. Second, just looking at GDP doesn't directly capture the effect on household incomes and living standards.

So what else might have led to the weakness in GDP? The most obvious alternative here is that this is all an international story, visible not just in the UK but in weak growth in countries like Italy and Japan. But weakness in other countries is a recent phenomenon. Looking back over the period since the referendum as a whole, this explanation doesn't stack up. In fact, the world has surprised to the upside since the referendum: the OBR's end-2018 forecast for the size of the UK's export markets was about 0.8 per cent higher in October 2018 than that made in March 2016. This suggests, if anything, that recent UK growth has been supported *more* by our export markets strength than was expected pre-referendum. This is in-line with research[2] that tries to quantify these other factors hitting the economy. Indeed, far from the UK's slower growth over the past two years being driven by a wider global slowdown, we slowed down while others sped up – moving from being about the strongest growing G7 economy to one of the weakest since the referendum. If UK GDP had grown in line with the G7 average, our economy would have been 0.7 per cent larger by 2018 Q3.

Figure 2: Since the referendum, the UK has moved from being one of the fastest growing G7 countries to one of the slowest

Four-quarter GDP growth for G7 countries (per cent)



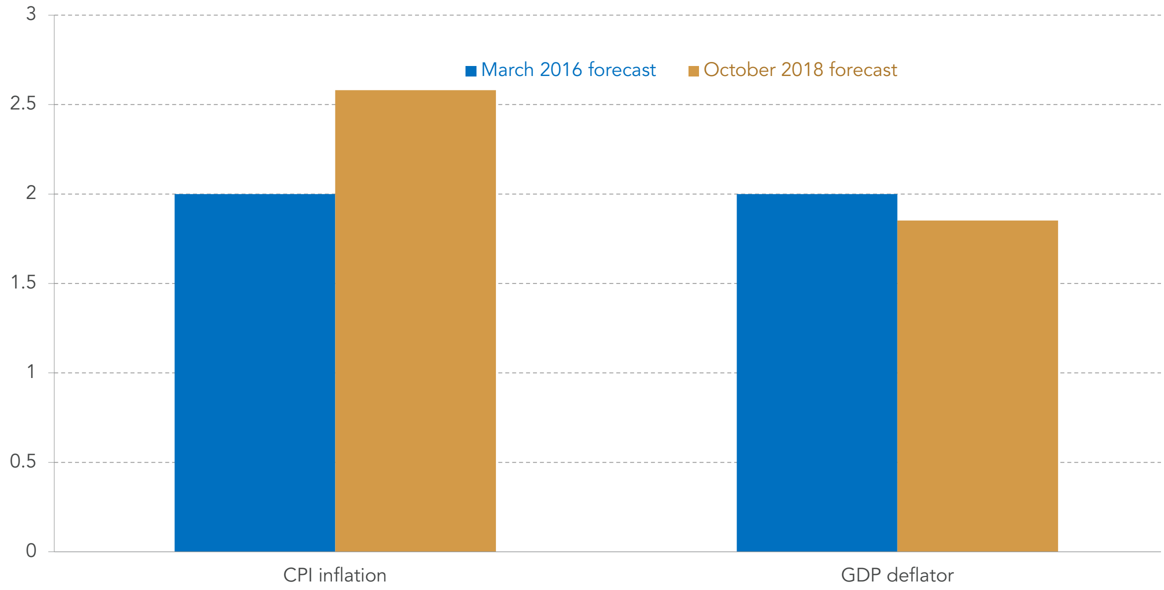
Notes: the swathe shows the range of four-quarter growth rates for G7 countries
Source: OECD

[2] Centre for European Reform, https://www.cer.eu/in-the-press/doppelg%C3%A4nger-uk-shows-britains-economy-23-smaller-because-brexit

But we need to go beyond GDP to get at the effect on what families ultimately care about – household living standards. This is particularly important because over the past few years the impact of Brexit on GDP is materially different to that on living standards. Most obviously, sterling's post-referendum depreciation will raise the price of imports and therefore of what we consume here in the UK (which is what matters for living standards), but not raise the price of our output (ie GDP) in the same way. The effect of what sounds like a technical change is that real household incomes take a bigger (or, more accurately, quicker) hit than GDP. This is despite continued strength in employment.[3]

Figure 3: Sterling's depreciation has led the prices of consumer goods to increase faster than those in the overall economy

OBR forecasts for Consumer Price Index and GDP deflator inflation in 2018 (per cent)



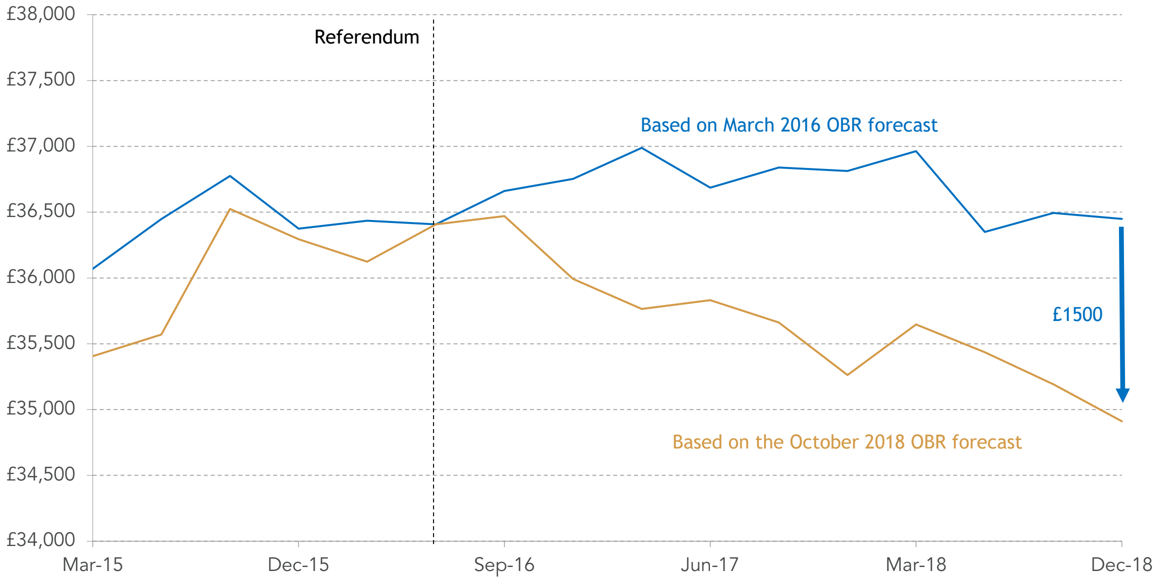
Source: OBR

To estimate the effect on households then, the chart below compares the OBR's pre-referendum forecast for real household labour income, adjusted for taxes and benefits, with one based on its October 2018 projection. This allows us to focus on the main component of typical household incomes, and shows that, by end-2018, annual household labour incomes are expected to be around £1,500 lower than they were before the referendum. In fact not only are they lower than previously forecast, they have actually been falling for the past two years.

[3] Resolution Foundation, Setting the record straight: how record employment has changed the UK, January 2019

Figure 4: Real incomes have turned out weaker than expected before the referendum

Forecasts for real household disposable labour income based on OBR forecasts (£)

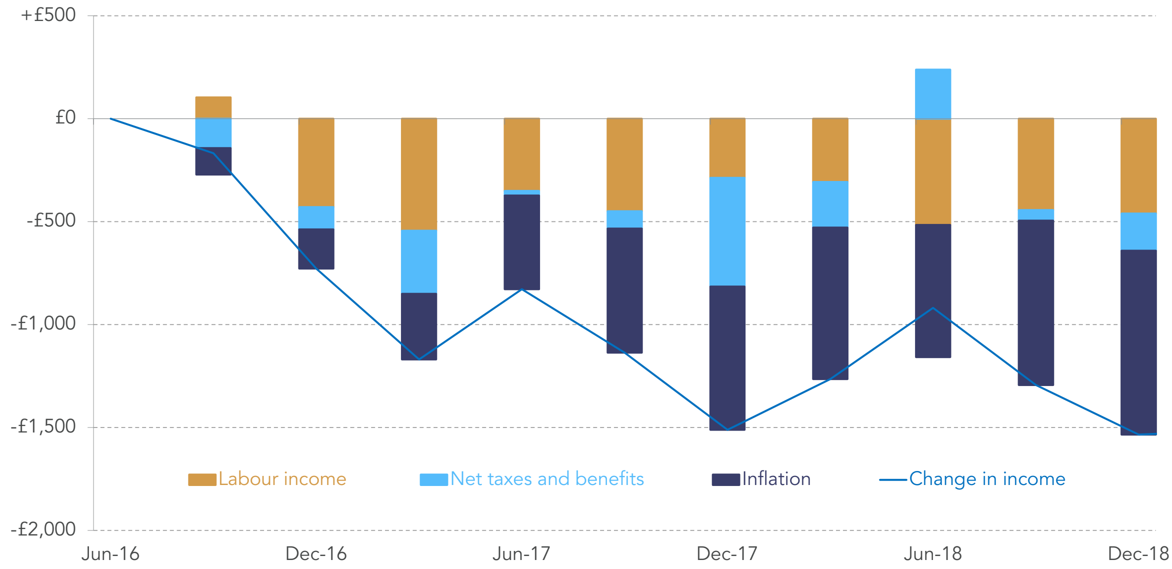


Source: OBR, ONS and RF calculations

Obviously we should avoid being too definitive in interpreting this much weaker than expected household income performance. After all such comparisons can be affected by a number of factors – the OBR's pre-referendum forecast could have been too optimistic, for example. But much of this reflects stronger inflation, as the decomposition chart below confirms – and that is overwhelmingly a direct effect of the UK's Brexit decision.

Figure 5: Higher inflation has depressed household incomes since the referendum

Change in the implied OBR forecast for real household disposable labour income (£)



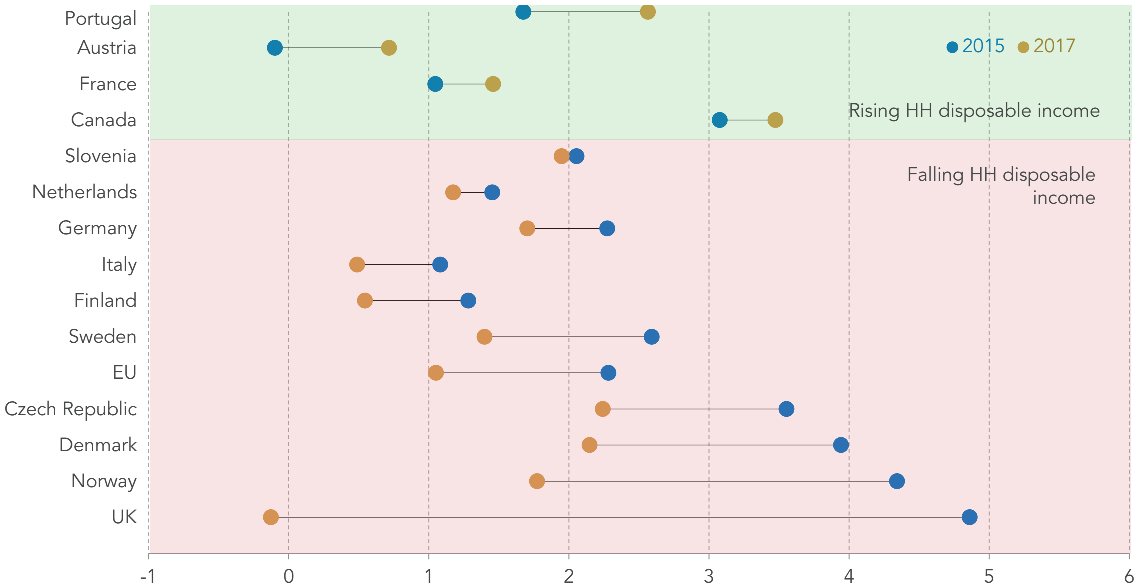
Notes: This measure focuses on labour income, changes in taxes and benefits and inflation. It strips out changes to non-labour income which can be more volatile and subject to revision. If non-labour income was included in this calculation, the fall in incomes would be significantly larger.
Source: OBR and RF calculations

Like GDP, UK income growth has been slower than seen in other countries since the referendum, cautioning against the idea that the UK's weak performance is simply part of a wider picture. The chart below shows real household disposable income growth for a group of advanced economies for which data are available from the OECD on an internationally comparable basis (and so focusing on overall household income). This data shows that UK income growth fell from 4.9 per cent before the referendum in 2015 to close to zero in 2017.

While some other advanced economies also saw disposable income growth slow, the fall in UK growth was by far the largest. Again it is difficult to say whether UK income growth would have remained stronger than that in other OECD countries in the absence of Brexit. After all, the growth in 2015 was very strong by recent standards. More usefully we can get a sense of how big the effect of the UK being an outlier in recent household income growth has been: if, instead of slowing sharply, UK real incomes had grown in line with the average rate seen in these OECD countries, annual household disposable incomes would have been around £2,000 higher by 2017.

Figure 6: Household income growth has slowed much more in the UK than in other rich countries

Real household disposable income growth for 2015 and 2017 for a range of OECD countries (per cent)



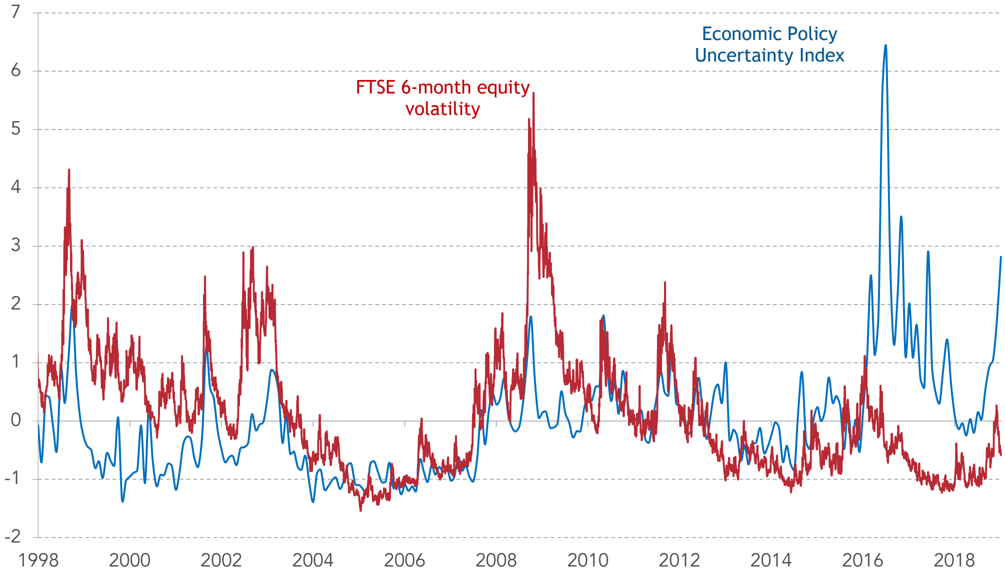
Notes: This measure includes wages and salaries, mixed income, net property income, net current transfers and social benefits other than social transfers in kind, less taxes on income and wealth and social security contributions paid by employees, the self-employed and the unemployed. It also includes income from government and non-profit institutions serving households to households.
Source: OECD

These data dives help to establish the extent to which UK households have seen real income hits post-referendum compared to the trajectory they were previously thought to be on, or that they would have seen if they had followed the experience of other countries in the same time period – something in the region of £1,500. No one can say definitely how much of that lost income is exclusively down to the Brexit effect but it's hard not to conclude that Brexit must be the single biggest factor. This deep dive also cannot distinguish between how much lower incomes are due to the decision to leave and how much is due to the messy process of trying to agree where we are leaving to. Again, there are good reasons for thinking that it is not just Brexit itself but also Westminster's handling of it that comes with a price tag.

We cannot clearly distinguish between the two, but it is fairly clear that political uncertainty is part of the issue and that it goes beyond that which is inevitable with any change on the scale of Brexit. There is certainly evidence that economic uncertainty has been picking up with political uncertainty recently – long after the actual decision to leave was taken. The chart below shows some timely measures of economic uncertainty, including a measure of Economic Policy Uncertainty. These measures have risen in recent weeks because of the politics not the economics of Brexit. Wider research suggests this could in and of itself provide unwelcome headwinds to living standards.

Figure 7: Measures of uncertainty have picked up in recent weeks

Measures of uncertainty (standard deviations from the mean)



Notes: Economic Policy Uncertainty Index (standard deviations from average) and implied volatility derived from FTSE options.
Source: Bank of England and 'Measuring Economic Policy Uncertainty' by Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com.

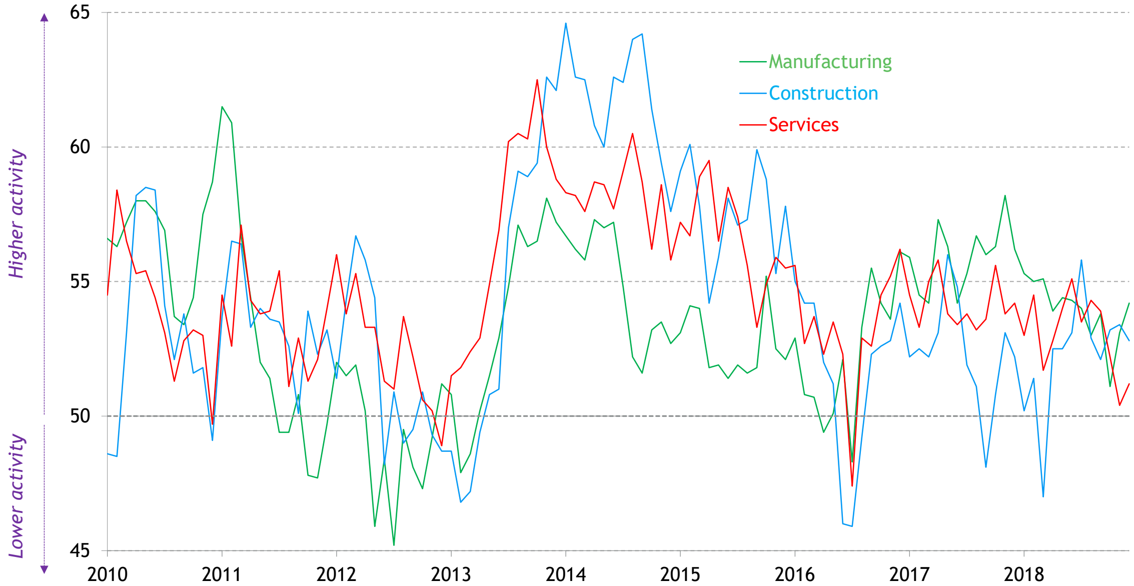
While it is not easy to map from such uncertainty measures to economic activity, research based on US data[4] suggests a rise in the index of Economic Policy Uncertainty of the order of magnitude seen here recently could reduce gross investment by around 1.5 per cent. Consistent with that, more timely measures of economic activity – such as the PMIs, shown below – have slowed sharply into January.

So Brexit appears to have significantly affected living standards already. And while it is impossible to be precise about exactly how large that effect is, the analysis above suggests the impact has been bigger on household living standards than the simple effect on GDP. Households' annual real disposable income is lower by something in the region of £1,500 compared to pre-referendum expectations, and the underperformance is greater compared to a baseline of UK incomes growing in line with its peers over the past few years.

[4] S Baker, N Bloom & S Davis, Measuring Economic Policy Uncertainty, March 2016

Figure 8: The PMIs have slowed sharply consistent with a further headwind from Brexit uncertainty

PMI Business Activity Index: 50 = no change



Source: IHS Markit/CIPS

As the Treasury[5] and NIESR[6] have pointed out, the long-term impact on living standards of Brexit will depend on the future relationship with the EU. But the analysis above adds two important perspectives to that. First, expectations about the long-term impact on living standards will affect families' living standards now, through lower investment and higher inflation. Second, it's not just the long-term destination that matters, how we get there is also important because uncertainty has a price. With evidence that uncertainty is rising, as politicians struggle to find a way to provide clarity over the UK's future links with the EU, the danger is that the headwinds to living standards growth will continue.

If politicians can find a way to reduce uncertainty, some of the lower investment may prove to be just postponed. But the longer the uncertainty lasts, the greater the risk that it is lost permanently. If that happens, our capital stock and our living standards will be permanently lower. All of this should encourage policy makers to recognise how much is at stake in the UK at present – and that how the country goes forward, not just where it is heading to, matters for household living standards.

[5] HM Treasury, EU Exit: Long-term Economic Analysis, November 2018
[6] A Hantzsche, A Kara & G Young, The economic effcets of the Government's proposed Brexit deal, November 2018

Resolution Foundation

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

- undertaking research and economic analysis to understand the challenges facing people on a low to middle income;
- developing practical and effective policy proposals; and
- engaging with policy makers and stakeholders to influence decision-making and bring about change.

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